IN THE

# Supreme Court Of The United States

NO._____

BURFORD-TOOTHAKER TRACTOR COMPANY,
Petitioner

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

Petition for certiorari to
the Circuit Court of Appeals
for the Fifth Circuit.

Petitioner, Burford-Toothaker Tractor Company, prays that this Court review by certiorari, under Section 1254 of the Judicial Code or any other statute applicable, the decision of the Circuit Court of Appeals for the Fifth Circuit rendered November 29, 1951, on which a petition for rehearing by petitioner was denied on December 7, 1951, (reported in 192 F$^2$ 633) affirming a decision of the Tax Court of the United States rendered August 28, 1950 (Reported in 9 T. C. M. 208).

**Summary and short statement of the matter involved.**

The matter involved is the petitioner's federal income tax liability for the years 1941, 1942 and 1943, the correct

amount of which depends upon whether the amount of compensation paid to petitioner's two managing officers, its President and Secretary, was reasonable and deductible under Internal Revenue Code 23 (a) providing in substance that "in computing net income there shall be allowed as deductions . . . all the ordinary and necessary expenses paid or incurred . . . including a reasonable allowance for salaries or other compensation for personal services actually rendered."

The pleadings in the Tax Court made the sole issue of fact the question whether the compensation paid was reasonable.

On the hearing in the Tax Court, the petitioner produced competent and informed witnesses who testified without contradiction or impeachment that the compensation was reasonable or in line with that paid by comparable companies. The respondent called no witnesses and offered no evidence contra.

The Tax Court disapproved both the amount paid and the amount fixed by the respondent and arbitrarily fixed an amount which had no support in the record.

It is petitioner's contention that where an issue of fact is made by the pleadings and proof is made by competent and informed witnesses who are not impeached in any way and no contra evidence is offered, the party who thus carries his burden of proof is entitled to prevail on the issues of fact thus made and fully proven.

Petitioner also contends that a previous decision of the Board of Tax Appeals approving the compensation of these identical officers computed on the same basis is res adjudicata here.

**The uncontroverted facts made by the record.**

The case went to the Tax Court on petition for redetermination (I. R. C. Section 871 (a) after the Respondent had fixed an arbitrary amount as the amount of officers' compensation and the issue there made by the pleadings (petition, R. 4, answer R. 33) was, as already stated, whether the compensation paid was reasonable. The uncontroverted facts on this issue are:

Petitioner is a closely held Alabama corporation. All its stock was owned by the two officers whose compensation is here involved, and their respective wives. The work and effort of the two officers was largely responsible for its growth and success. Since its organization in 1935 these two officers had been paid a fixed annual salary of $9,000.00 plus 2% of the gross sales in excess of $300,000.00, except in 1935, when the percentage was slightly higher.

The first three full years of the company's existence produced the following results:

| Year | Gross sales | Compensation paid each officer |
|---|---|---|
| 1935 | $430,773.00 | $11,769.00 |
| 1936 | $699,988.00 | $16,400.00 |
| 1937 | $874,660.00 | $20,493.00 |

Part of the compensation for those three years was disallowed by the respondent but on petition for redetermination the Board of Tax Appeals approved the full amount paid for each year. (1940 B. T. A. Docket Number 100911.)

The same basis was continued for the next three years and was approved by the Commissioner's Technical Staff. These figures were:

| Year | Gross sales | Compensation paid each |
|---|---|---|
| 1938 | $ 730,116.00 | $17,602.00 |
| 1939 | $1,013,260.00 | $23,265.00 |
| 1940 | $1,211,558.00 | $27,231.00 |

The Board of Tax Appeals decision approving the amount computed on the percentage basis for 1935-6-7 was rendered October 20, 1941. Petitioner, for that year, and the two following years, which are those in issue here, continued to pay its two officers on the same basis with the following result:

| Year | Gross sales | Compensation paid each |
|---|---|---|
| 1941 | $1,846,151.00 | $39,922.00 |
| 1942 | $2,280,348.00 | $48,606.50 |
| 1943 | $1,562,840.00 | $34,246.50 |

The Commissioner disallowed all compensation in excess of an arbitrary figure of $25,000.00 for each year. On petition for redetermination the amount fixed by the Tax Court is shown in the following tabulation:

| Year | Amount paid | Fixed by Commissioner | Fixed by Tax Court |
|---|---|---|---|
| 1941 | $39,922.00 | $25,000.00 | $37,500.00 |
| 1942 | $48,606.50 | $25,000.00 | $40,000.00 |
| 1943 | $34,246.50 | $25,000.00 | $30,000.00 |

The amount fixed by the Tax Court had no mathematical relationship to the gross sales and petitioner contends that it had no support in the evidence.

The reduction by the Tax Court was:

| | |
|---|---|
| 1941 | $2922.00 |
| 1942 | $8606.50 |
| 1943 | $4246.50 |

That the compensation was paid without any sacrifice to the financial well-being of the corporation is shown by the undisputed fact that during each of the three years the corporation paid an 8% dividend on its corporate stock and more emphatically by the fact that during the three year period, petitioner's surplus increased from approximately $94,000.00 at the beginning of the period to $354,000.00 at the close, an increase of $260,000.00, or upwards of double its $150,000.00 capital.

The results produced are reflected in the sales volume for the three years in question which was upwards of three times the total for the preceding three years or $5,689,300.47 as compared to $1,975,422.64.

The work of these two officers is described by the Tax Court in its findings of fact, excerpts from which are: (R. 40)

> "The petitioner's business was managed and supervised solely by its two officers, Burford and Toothaker. They worked together as a team. They devoted all of their time to the business, working six days a week, an average of two or three nights a week, and often on Sunday. They participated in various ways in most sales."
>
> "During the years in question petitioner's officers had additional work because of the Draft Boards (in attempting to secure deferments for certain vital employees), and war regulations."
>
> "The big problem after 1941 was the acquisition of machinery (new and used) to sell. One method used to alleviate this problem was to obtain new lines from other manufacturers to help fill out the scarcity of new equipment needed." (R 41)
>
> "During the taxable years it was difficult to obtain employees with experience to work for petitioner."
>
> "Petitioner's two officers interviewed all new employees and supervised their training."
>
> "The operation of the petitioner required borrowing from banks which was at one time during the taxable years as high as $425,000. All of these borrowings were individually guaranteed by the endorsement of Burford and Toothaker, who together had a net worth of approximately $500,000."

Their compensation was fixed by corporate resolutions each year and had been uniform since 1936.

It is petitioner's contention that under the uncontroverted evidence, the compensation was reasonable.

**Witnesses in Tax Court Hearing.**

On the hearing in the Tax Court there were but four witnesses. They were petitioner's witnesses and no witnesses were called by the respondent. Briefly stated the testimony was:

Petitioner's president, Toothaker, (R 76) testified, among other things, that in his previous employment with another concern (Lombard Company) in similar business where he owned no stock, had no financial risk and had fewer duties, his compensation was on a salary and percentage of sales basis which would have resulted in substantially larger compensation, on petitioner's volume of sales, than actually resulted under the arrangement with petitioner. His total from petitioner for the three years was $122,775.00 as compared to what it would have been on the Lombard basis, namely $177,811.83. He testified that his own compensation was reasonable for each year and that of the other officer, Burford, was likewise reasonable.

The witness, Sybil Young, (R 54) corroborated Toothaker's testimony as to his arrangement for compensation with the Lombard Company.

Petitioner's secretary, Burford, testified, (R 55) among other things, that his own compensation and the amount paid Toothaker was reasonable.

The fourth witness, Aldridge, a certified public accountant with many years experience, familiar with petitioner's business and six other similar concerns, testified (R 71) that based on his knowledge and experience the compensation paid these officers was reasonable and in

fact less than one other similar concern where larger compensation was paid and the volume was substantially less than petitioner's.

No effort was made by respondent to impeach or contradict either of these four witnesses and, as stated, no evidence contrary was offered.

A comparison of the total compensation of the two officers with the gross sales for all years since and including 1936 is:

| Year | Total sales | Total compensation of officers | Percentage of compensation to sales |
|---|---|---|---|
| * 1936 | $ 699,988.00 | $32,800.00 | 4.9 |
| * 1937 | $ 874,660.00 | $40,986.00 | 4.7 |
| **1938 | $ 730,116.00 | $35,204.00 | 4.8 |
| **1939 | $1,013,260.00 | $46,530.00 | 4.6 |
| **1940 | $1,211,558.00 | $54,462.00 | 4.5 |
| 1941 | $1,846,111.00 | $79,844.00 | 4.3 |
| 1942 | $2,280,348.00 | $97,213.00 | 4.3 |
| 1943 | $1,562,840.00 | $68,492.00 | 4.4 |

A similar comparison of officers compensation to gross profit is:

| Year | Gross profit | Total compensation of officers | Percentage of compensation to gross profit |
|---|---|---|---|
| * 1936 | $55,540.00 | $32,800.00 | 59.1 |
| * 1937 | $64,980.00 | $40,986.00 | 63.1 |
| **1938 | $53,432.00 | $35,204.00 | 65.9 |
| **1939 | $85,193.00 | $46,530.00 | 54.6 |
| **1940 | $95,497.00 | $54,462.00 | 57.0 |
| 1941 | $162,422.00 | $79,844.00 | 49.2 |
| 1942 | $396,815.00 | $97,213.00 | 25.5 |
| 1943 | $267,435.00 | $68,492.00 | 25.6 |

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* Approved by Board of Tax Appeals.
** Approved by Technical Staff.

It was also undisputed that in addition to their duties in normal years as those involved in the Board of Tax Appeals decision approving the amount of their compensation figured on the same basis as here, the two officers had many more duties and problems because of the war effort, including the following:

a. The problem of obtaining new equipment for sale due to the fact that all but a small percentage of all the new equipment available was required by the government, thus making it much more difficult to obtain new equipment for sale.

b. The priorities imposed during those years with reference to new machinery increased their work in assisting their customers in obtaining priorities.

c. They lost many of their employees including some of their key personnel which required extra work in employing and training new employees in a business in which it is difficult to find employees already trained.

d. There was added work in connection with the draft which required their effort in attempting to hold their employees on the ground that the business in which the company was engaged was a critical one in the war effort.

e. There were many and complicated war regulations to be studied to which their business had to be adjusted.

f. The shortage of new equipment necessitated their working in the used equipment field in an effort to maintain their dollar volume and in which there was keen competition among those seeking to buy for resale.

g. The shortage of new machinery in their usual line made it necessary for them to seek and obtain other lines of machinery for sale.

h. There would have been testimony of other added work caused by war conditions but while Burford was tes-

tifying on this subject the Tax Court judge stopped him and indicated that it was not necessary to go farther into that.

Although these facts were undisputed the Tax Court nevertheless discarded the amount arrived at on the same basis as in all the previous years of the company's existence (and testified to by all witnesses as being reasonable) and substituted a figure having no support in the evidence, a figure which petitioner contends is arbitrary.

**Statement particularly disclosing the basis upon which it is contended that this court has jurisdiction. Rule 38 (5).**

1. The jurisdiction of federal appellate courts to review the Tax Court on questions of fact is in Section 441 (a) of the Internal Revenue Code as amended in 1948 which vests in those courts jurisdiction to review the Tax Court "in the same manner or to the same extent as decisions of the district courts in civil actions tried without a jury . . ."

The Circuit Court should have reversed the Tax Court for having disregarded the evidence and the testimony of qualified witnesses on a question of fact and having fixed an amount having no support in the evidence.

The decision of Circuit Court of Appeals in affirming the Tax Court when all the witnesses testified that the compensation was reasonable is in conflict with the following decision of another circuit court.

**Wright-Bernet, Inc. vs. Commissioner,**
**172 F² 343, CCA 6.**

**Roth Equipment Company vs. Gallagher,**
**172 F² 452, CCA 6.**

because in the Wright-Bernet case it was held:

> "We bear in mind that the findings of fact are not to be set aside unless **clearly erroneous**, and that due regard must be given to the opportunity of the trial

court to judge of the credibility of the witnesses, Rule 52 (a), Federal Rules of Civil Procedure, 28 U. S. C. A.; but the credibility of the witnesses was not attacked here in any way. The Tax Court in its findings of fact adopted and reiterated the material evidence introduced by the petitioner, and then decided that the compensation of each employee for one year was unreasonable in the amount of $140, and for the second year in a greater amount. **As the petitioner's witnesses were qualified and unimpeached, and no evidence was given to the contrary, their testimony should have been accepted.** Capital-Barg Dry Cleaning Co. v. Commissioner, 6 Cir., 131 F 2d 712." (Emphasis supplied)

And in the **Roth** case it was held:

"We are of the opinion that the findings of the District Court on the issue of the reasonableness of the compensation for 1942 were clearly erroneous and should be set aside. There was little, if any, dispute in the evidence. The appellee offered no witnesses in support of his position. No witness testified that the amounts found by the District Court as reasonable compensation in 1942 was the reasonable compensation to which the officers were entitled. The only direct evidence before the Court on the specific question of reasonableness of compensation was the testimony of Harold Hampton and Archie Shearer, both well-qualified, impartial witnesses, with many years of experience. They testified that in their opinion the compensation was reasonable, with Mr. Hampton referring it as "very reasonable." The credibility of these witnesses was not put in issue. The appellee offered no witness to contradict this testimony or to testify in any way that the compensation was unreasonable to any extent. On this crucial and single issue of fact in this case this unimpeached, uncontradicted testi-

mony from well qualified, impartial witnesses can not be disregarded by the Court. **This court has several times stated that such testimony should be accepted by the fact finder in a matter in which the fact finder has no knowledge or experience upon which he could exercise an independent judgment.**" (Emphasis supplied)

2. The decision of the Circuit Court of Appeals in affirming the Tax Court in the instant case is in conflict with its own decision in **J. H. Robinson Truck Lines vs. Commissioner,** 183 $F^2$ 739, where the court held that where the issue is whether compensation paid to a corporation president, who owned all but three shares of its stock, was reasonable, the Tax Court may not reject the credible testimony of competent witnesses who testify without contradiction or impeachment and, upon a record containing no contrary evidence, determine that salaries paid are unreasonable and substitute in lieu thereof an arbitrary amount determined "not upon the evidence, but apparently upon its own innate conception of reasonableness." (Quoted from Hightower Vs. Commissioner CCA5 187 $F^2$ 535 in commenting on the Robinson Case)

3. Whether the Tax Court may, in a case such as this, do what the Fifth Circuit Court in the **Robinson** case, and the Sixth Circuit Court in its two cited cases said it cannot do and what in the instant case the Fifth Circuit Court now says it can do, is an important question in federal law which has not been but should be settled by this court.

4. In deciding this case as it has, the Circuit Court has so far sanctioned a departure by the Tax Court from the accepted and usual course of judicial proceedings as to call for an exercise of this court's power of supervision.

5. The question decided in this case is one of general importance relating to the federal income tax laws and has not been but should be settled by this court.

## The Questions Presented.

1. In a case where the issue of fact is whether compensation for services paid by a taxpayer to its employees and deducted as an expense under the federal income tax law is reasonable, may the Tax Court reject the credible testimony of competent witnesses who testify without contradiction or impeachment and upon a record containing no contrary evidence determine that salaries paid are unreasonable and substitute an arbitrary amount having no support in the record?

2. Where the Tax Court in a previous decision, (rendered when it was called the Board of Tax Appelas) has approved as reasonable the amount of compensation paid by a corporation to its two chief officers arrived at on the basis of a certain fixed salary plus a percentage of gross sales for the first three full years of the corporation's existence and the amount arrived at on the same basis for the next three years has been approved by the Technical Staff, may the Tax Court reject the credible testimony of competent witnesses who testify without contradiction and on a record containing no contrary evidence determine that the compensation paid the two identical officers and computed on the identical basis is unreasonable and substitute an amount having no support in the evidence?

## Reasons relied on for the allowance of the writ.

1. It is important for closely held corporate taxpayers to know by a decision of this Court whether they can pay their officers on a fixed salary plus a percentage of gross sales basis.

2. Also, to so know whether they can pay compensation on that basis especially where the basis has been established over a period of years.

3. To so know whether in such a case, the large increase of volume accomplished under the management of

officers working on such a basis, is justification for a court to arbitrarily reduce the amount of compensation resulting therefrom.

4. To so know whether the officers in such a case who have taken small compensation in lean beginning years can be rightly deprived of their proportionately larger compensation in better years, especially when the dollars in the "better" years are of greatly less value.

5. To so know, as indicated in the Circuit Court's opinion quoting from the **Locke Machine Company** case, whether the fact that "the Government . . . needs tax income" should alter the established basis of a corporation compensating its officers.

6. It is important also for the respondent Commission to have this court decide the questions here involved, as an aid in administering the federal income tax statutes.

7. It is important for all parties concerned in handling disputed cases of this kind to know by a decision of this Court whether, in a case where the evidence on an issue of fact is to the effect that the amount of compensation is reasonable and not greater than other employees pay for similar services, the Tax Court may disregard the testimony of witnesses who, by their knowledge and experience are qualified to know and testify, and arbitrarily fix an amount taken not from the evidence but from the personal ideas of the judge writing the opinion who may not be himself informed at all as to what such services are worth.

8. It is important for the Court to hold that where, in a case involving the isssue of fact as to the reasonableness of officer compensation, the only testimony is to the effect that the compensation is reasonable and in line with what other comparable companies pay and there is no evidence contra, the Tax Court may not go outside of the record and make a finding drawn from its own independent ideas.

9. It is important for the Court to hold that the evidence, and not one judge's own notion, should govern the decision on an issue of fact.

10. Consistent with the principle that ours is a government of laws and not of men, a taxpayer should not be exposed to the uncertainty of what one judge might think, based on his own notions, irrespective of uncontroverted and credible evidence.

11. Consistent with the principle that legal rights should be known and certain and not otherwise, it is important that this Court hold that where the Board of Tax Appeals has approved the amount of officer compensation computed on a fixed amount plus a definite percent of sales for certain individuals serving as corporate officers for certain years, the corporation is justified in continuing to pay on that basis and should not be penalized with heavy interest (six years or 36% on part) for having relied upon apparent official as well as court approval of its method of compensating those individuals.

12. Under the rule of res adjudicata, equitable estoppel or elementary justice, this Court should intervene to prevent the imposition of additional federal income tax where a corporation has been assessed with deficiencies by the Tax Court disallowing part of the compensation paid its officers on the identical fixed salary and percentage of sales basis as in previous years when the amount was approved by the Board of Tax Appeals.

Respectfully submitted,

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February 1952

I hereby certify that I have served a copy of the foregoing by mailing a copy to Hon. Ellis N. Slack, Special Assistant to the Attorney General, Department of Justice, Washington, D. C., on this ____ day of February, 1952.

_____

Attorney for petitioner

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IN THE

# SUPREME COURT OF THE UNITED STATES

BURFORD-TOOTHAKER TRACTOR COMPANY,
Petitioner.

vs.

COLLECTOR OF INTERNAL REVENUE
Respondent.

On petition for certiorari to the Circuit Court of Appeals for the Fifth Circuit.

## BRIEF IN SUPPORT OF PETITION

FRED S. BALL, JR.,
Attorney for petitioner

## DECISIONS OF LOWER COURTS

The Tax Court decision is reported in 9 T. C. M. 208. The Circuit Court decision is reported in 192 6$^2$ 633.

## GROUNDS FOR JURISDICTION

### Conflict between Circuit Courts

1. The decision of the United States Circuit Court of Appeals for the Fifth Circuit below is in conflict with the decisions of the Sixth Circuit in:

**Wright-Bernet Inc. vs. Commissioner, 172 F$^2$ 343, and**

**Roth Equipment Co. vs. Gallagher, 172 F$^2$ 452,**

as well as its own decision in:

**J. H. Robinson Truck Lines vs. Commissioner, 183 F$^2$ 739.**

**The instant decision follows the dissent in the Robinson case instead of the majority decision of the Court.**

**Departure from usual course.**

2. The United States Circuit Court of Appeals has so far sanctioned the departure by the Tax Court from the adopted and usual course of judicial proceedings as to call for an exercise of this Court's power of supervision, in failing to accept the testimony of qualified, informed and unimpeached witnesses where there was no contrary evidence offered and in rendering a judgment unsupported by any evidence in the record.

**Construction of 23 a Internal Revenue Code.**

3. It is important for this court to construe Section 23 a of the Internal Revenue Code allowing as a federal income tax deduction a "reasonable allowance" for compensation for personal services rendered by officers in a closely held corporation. Nobody knows what is meant by reasonable, or how to determine, even approximately, how much can be legally paid.

**General importance.**

4. The question here is one of general importance relating to federal income tax laws and has not been but should be settled by this Court.

**Concise Statement of the Case.**

This is set out in the petition for certiorari beginning at page 1, entitled "Summary and Short Statement of the matters involved." It would seem needless to repeat it here.

## ARGUMENT

**Preliminary Statement**

There are a multitude of closely held corporations in this country in which the chief owners are also the manag-

ing heads to whom the corporations are, by the federal revenue law, allowed to pay compensation for their personal services and to deduct it as an expense in computing their federal income tax (I. R. C. 23 a).

The directors of these closely held corporations must decide each year what amount can lawfully be paid.

This is a dangerous decision to be made. Whatever compensation is paid must be returned by the individuals in their own income tax returns and the tax is often in about as high brackets as the corporation (true in the case at bar). They know that it may be nearly three years before they will be audited by the Revenue Bureau and in the meantime upwards of 36% interest will have accrued on any deficiency determined, and likely much more, as everyone knows the Dickens-like delay in final judicial tax determination. (The taxes here begin with the year 1941 on which ten years or approximately 60% interest would have accrued).

It is a dangerous decision also because they know, too, that if part of the officer's compensation is eventually disallowed and the corporation is required to pay additional taxes, there is no refund to the individual officers as is the case of husband and wife partnerships when wholly or partially disallowed.

How then may prudent business people know what amount is to be considered "reasonable" and be legally paid?

They must find out what is meant by "reasonable."

If they open the latest published volume of Corpus Juris Secondum, at page 634 (Vol. 75) they will read:

> "The word 'reasonable' is a relative generic term difficult of adequate definition. While it has been said that it is an ordinary word in common use and fa-

miliar to the average person, in fact the dictionaries give a number of meanings for the word, and it has various shades of meaning, and the particular shade is to be determined according to the context and circumstances of each particular case.

" 'Reasonable' is defined as meaning agreeable to reason; conformable to reason; governed by reason; having the faculty of reason; rational; thinking, speaking, or acting rationally, or according to the dictates of reason; sensible.

"It is also defined as meaning just; proper; fair; equitable; and, in addition, the term has been construed as meaning honest. 'Reasonable' is further defined as meaning ordinary or usual; not immoderate or excessive; not capricious, arbitrary, or confiscatory."

If they turn to the standard work on the meaning of words, "Words and Phrases, Permanent Edition, Volume 36, they will find 169 pages of case digests defining the word "reasonable."

The only guide provided by law is that the amount be "reasonable."

How may business people directing the affairs of their corporations know what amount is "reasonable?"

If it is a factual matter, where may they go to find out what is "reasonable?"

Should they go to other people and ask what is "usual," as for instance, a certified public accountant who audits other comparable concerns and is in position to know what others pay?

Suppose then, with this decision to make in the first year of the company's existence upon advice thus obtained, they decide upon a merit or incentive system, providing

for a fixed salary of modest proportions plus a percentage of gross annual sales in excess of a substantial minimum and they set up this plan and continue to use it each year. After a while, they get "checked" by a Revenue Agent and he disallows part of what was paid and fixes an amount selected by him as being reasonable—being certain, it always seems, to select a figure which will make the company pay considerably more income tax—and without any resulting refund to the individuals who, in the meantime have paid income tax on the amount paid them by the corporation.

Suppose they then go to the Board of Tax Appeals with their troubles and on the hearing, in addition to their own testimony which includes testimony as to a closely similar method used by another comparable company by whom one of them had been previously employed, which, if used by them would have produced larger compensation, the certified public accountant testified that the compensation was reasonable and in line with other comparable concerns and the Board, in its decision, approves the amount as "reasonable."

Would they then be safe in continuing the same plan? Suppose they did continue it and the next three years are approved by the Technical Staff people who have large authority in such matters. Would they then be safe in continuing further? Suppose they do, and again the agent comes and again he reduces the amount and again they go to the same Board of Tax Appeals which by then is called by another name—The Tax Court. This time as before, there is the same testimony from the same witnesses as before and again no one is there who testifies against the company witnesses and no question is raised as to their integrity or effort made to impeach their testimony. But this time a different judge hears the case and although all the testimony was that the compensation was reasonable

and in line with comparable companies this particular judge has ideas of his own. He disagrees with the Agent's arbitrary amount but rejects the witnesses' testimony that the amount was reasonable and customary, and substitutes from his own mind a figure selected by him as being the amount which the company could have properly paid.

Nine years later, in 1950, these business people find that the amount their corporation paid them in 1941 based on the same plan of computation as in all the previous years of the company's existence (except the first, when it was a little larger) approved by the Board and later by the Technical Staff, was unreasonable!

Bewildered, they go to the Circuit Court hoping for relief there, but the Court turns its head and quotes something about the Government "needs tax income most vitally." (R 93)

These suppositions are the facts of this case and these people are now here at the end of the judicial road asking that this Court do something about it,—not only for their own sake, but for the sake of the multitude of other business people who are entitled to know what their tax bill is, or at least to have some idea, without the penalty which these have suffered as a result of a judge valuing his own personal opinion above the testimony of informed witnesses.

This Court should take this case and define what is meant by "reasonable" in relation to closely held corporation officers' compensation.

It is petitioner's contention, among others set out in the petition, that under the American system of litigating cases before the courts, it is a basic rule that where an issue of fact is made by the pleadings, and proof is made by the credible testimony of competent, informed witnesses and no contrary evidence is offered, the party who

thus carries his burden of proof is, as a matter of law, entitled to prevail on the issues of fact thus made and proven.

To this general rule, of course, there is the possible exception where there is a legal presumption to be overcome. Thus, in this, a federal income tax case, the Commissioner's determination is presumed to be correct and the burden is upon the taxpayer to overcome the presumption. The presumption was overcome in this case when the Tax Court declined to sustain the Commissioner's determination.

**Cases relied upon by Circuit Court.**

This case is not similar to **Dayton P & L Company vs. Commissioner,** 292 U. S. 290, apparently relied upon by the Circuit Court, where certain property valuations in a natural gas rate case were involved and there was a conflict in the opinion evidence as to the value of certain gas leases. There was a conflict in the testimony there which called for judicial determination. In the case at bar there was no such conflict. The respondent offered no witness to testify that the compensation was either unreasonable or out of line with what other comparable companies were paying at that time for similar services.

The case of **Helvering vs. National Grocery Company,** 304 U. S. 282, cited and relied upon by the Circuit Court, if in point at all, is contrary to the Circuit Court's decision. That case involved the question of a corporate taxpayer accumulating an excess of surplus. The Commissioner determined that the surplus exceeded reasonable needs and the Board of Tax Appeals sustained the determination. The Circuit Court reversed and made its own finding, but this Court sustained the Board on the ground that the Circuit Court could only determine "whether there was evidence to support the Board's findings" and should not have made an independent determination of the matters which had

been at issue before the Board" (Emphasis added). In that case there was also a presumption which apparently the taxpayer was **not** able to overcome as is shown by the fact that the Board sustained the Commissioner. Also, in that case there was a **conflict** in the testimony as there were "twenty-four exhibits introduced by the taxpayer, eleven by the Commissioner." With a presumption to be overcome and a conflict in the testimony, this Court held that the Board was not obligated to accept as sound the opinion of the taxpayer's experts. This, in effect, was a holding that in such a case the Board did not have to accept opinion evidence as overturning a presumption.

In the case at bar the presumption was overcome when the Tax Court declined to sustain the Commissioner's determination. When it made its own **"independent determination"** it did what this Court held should not have been done by the Circuit Court in the **National Grocery** case.

**Conflict with Sixth Circuit.**

Contrary to the decision of the Circuit Court below, the Sixth Circuit under similar circumstances held that the taxpayer is entitled to prevail. In **Wright-Bernet vs. Commissioner,** 172 F$^2$ 343, a case involving the compensation of corporation officers, there was a determination by the Commissioner, a petition to the Tax Court for redetermination, and on the hearing the issue was whether the compensation was reasonable. The taxpayer's witnesses, most of whom were its own employees, testified that the compensation was reasonable and in line with what other companies paid. The Tax Court did not sustain the Commissioner's determination but substituted an arbitrary figure of its own, determining what was a reasonable amount in each instance. On review the Circuit Court held that " . . . the simple question before the Tax Court was the

reasonableness of the compensation. This, of course, is a **question of fact.**" (Emphasis added) After stating that the rule under 26 U. S. C. A. 1141 (a) is that the Circuit Court reviews the Tax Court "in the same manner and to the same extent as a decision of the District Court in civil actions without a jury," the court stated the rule to be:

> "The findings of fact of the Court below to the extent that they are unsupported by substantial evidence, or are clearly against the weight of the evidence, or were induced by an erroneous view of the law are not binding upon this Court."

The court then wrote:

> "We bear in mind that the findings of fact are not to be set aside unless clearly erroneous, and that due regard must be given to the opportunity of the trial court to judge of the credibility of the witnesses, Rule 52 (a), Federal Rules of Civil Procedure, 28 U. S. C. A.; but the credibility of the witnesses was not attacked here in any way. The Tax Court in its findings of fact adopted and reiterated the material evidence introduced by the petitioner, and then decided that the compensation of each employee for one year was unreasonable in the amount of $140, and for the second year in a greater amount. As the petitioner's witnesses were qualified and unimpeached, and no evidence was given to the contrary, their testimony should have been accepted. **Capital-Barg Dry Cleaning Co. v. Commissioner,** 6 Cir., 131 F 2d 712.
>
> "Viewing the case from another angle, no substantial evidence supports the decision of the Tax Court. The substantial evidence supports the reasonableness of the salaries."

**Roth Office Equipment Company vs. Gallagher,** 172 F[2] 452, is also a Sixth Circuit case involving reasonableness

of corporation officers' compensation where, after a determination by the Commissioner, the taxpayer paid the deficiency and sued in the District Court. That court disregarded the uncontradicted testimony and made an independent determination of its own as to what amounts would be reasonable in one of the years. On appeal the Circuit Court wrote:

> "We are of the opinion that the findings of the District Court on the issue of the reasonableness of the compensation for 1942 were clearly erroneous and should be set aside. There was little, if any, dispute in the evidence. The appellee offered no witnesses in support of his position. No witness testified that the amounts found by the District Court as reasonable compensation in 1942 was the reasonable compensation to which the officers were entitled. The only direct evidence which the Court on the specific question of reasonableness of compensation was the testimony of Harold Hampton and Archie Shearer, both well-qualified, impartial witnesses, with many years of experience. They testified that in their opinion the compensation was reasonable, with Mr. Hampton referring to it as "very reasonable." The credibility of these witnesses was not put in issue. The appellee offered no witness to contradict this testimony or to testify in any way that the compensation was unreasonable to any extent. On this crucial and single issue of fact in this case this unimpeached, uncontradicted testimony from well-qualified, impartial witnesses can not be disregarded by the Court. This Court has several times stated that such testimony should be accepted by the fact-finder in a matter in which the fact-finder has no knowledge or experience upon which he could exercise an independent judgment. **Capitol-Barg Dry Cleaning Co. v. Commissioner, 6 Cir., 131 F. 2d 712, 715; Toledo Grain & Milling**

**Co. v. Commissioner,** 6 Cir., 62 F. 2d 171, 173. See **Lawton v. Commissioner,** 6 Cir., 164 F. 2d 380, 384; **Weizer v. Commissioner,** 6 Cir., 165 F. 2d 772, 775. As was pointed out in **T. P. Taylor & Co. v. Glenn,** D. C. W. D. Ky., 62 F. Supp. 495, 499, if the compensation paid is unreasonable the appellee certainly could have produced some experienced witness from the industry who would have said so, and the failure to offer such a witness on the crucial issue in the case operates very strongly against his contention. The burden of proof in cases of this kind is upon the taxpayer, but we are of the opinion that that burden has been met when the taxpayer introduces uncontradicted, unimpeached testimony from well-qualified, impartial witnesses sustaining its contention, unless the established facts themselves are such as to show that such testimony ought not to be accepted."[1]

**Conflict with its own decision—confusion.**

Curiously enough, and to add to the confusion, the majority opinion of the court in its own case of **J. H. Robinson Truck Lines vs. Commissioner,** 183 F[2] 739, C. C. A. 5, was in accord with the two Sixth Circuit cases first cited. Another case where the Commissioner made a determination disallowing part of the officers' compensation and the Tax Court, while not accepting his determination, disregarded the uncontroverted testimony and arbitrarily reduced the amount paid. The Court wrote:

"Here, pointing to the fact that it offered evidence fully and completely supporting the reasonableness of the deductions claimed and the Commissioner

[1] The final statement in the opinion as to whether the established facts themselves are such as to show that such testimony ought not be accepted may necessitate an examination of the facts of the case at bar for that purpose and these will presently be more fully set out than are outlined in the petition.

offered no evidence whatever, petitioner insists that the finding and judgment of the Tax Court is not only clearly erroneous but is without any support in the evidence and may not stand. We agree.

"To support its claim that the salary it paid Robinson, as president, and the rents it paid him as landlord were reasonable, petitioner introduced the testimony of Robinson and of two other witnesses. Robinson testified positively, and without contradiction or impeachment, that the salaries paid him were in line with, that is were comparable to, salaries paid presidents of other similar lines.

"As to the rents paid him, he testified that they were reasonable, indeed were less than rents the corporation paid others.

"The other two witnesses testified positively and without equivocation, contradiction, or impeachment, that the salaries paid Robinson were in line with, that is the same as, salaries paid to presidents of similar companies, and that the rents paid to Robinson were reasonable and compared favorably with rents charged by others, indeed were considerably less than were paid by and to others in similar circumstances.

"The Commissioner offered no evidence.

"The Tax Court rejected all of the evidence of all of the witnesses, and upon a record containing no evidence whatever supporting them, sustained the Commissioner's determinations that the rents and salaries were excessive.

"Upon settled principles, it cannot do this, and in doing so, it erred."

There was a dissent by one judge, which the decision here follows.

In **Hightower vs. Commissioner,** 187 F$^2$ 535, CCA 5, mentioned by the Circuit Court in the case at bar, the taxpayer failed to overcome the prescription in favor of the Commissioner's determination and the Fifth Circuit affirmed but in so doing it mentioned its **Robinson** case and wrote:

> "Petitioner's reliance on **Robinson Truck Lines v. Commissioner,** 5 Cir., 183 F. 2d 739, will not at all do. There the taxpayer supported his position by disinterested and uncontradicted testimony, credible in itself and not impeached in any way. The Commissioner offered no testimony, and the Tax Court, not upon the evidence but apparently upon its own innate conception of reasonableness, sustained the Commissioner's determination.
>
> **"We quite properly held there that this amounted to little more than fiating."** (Emphasis added)

The rule should be, it is submitted, that where the credible testimony of qualified and unimpeached witnesses on an issue of fact is met by none in opposition, and there is no presumption to be considered, the testimony of these witnesses should **not** be arbitrarily disregarded as was done by the Tax Court here.

As a practical matter, it does seem in this case as was pointed out in **T. P. Taylor vs. Glenn, supra** that if there was any room for a difference of opinion as to whether the compensation paid here was reasonable, the Commissioner, with all the resources at his command, could have found and produced competent witnesses to testify that it was excessive. The fact that the Commissioner did not produce such a witness would indicate that no witness with the necessary qualifications could be found who could conscientiously testify that the compensation paid here was unreasonable.

If no such witnesses could be found, the Tax Court, as a **court** and not an investigating committee, should act **only** on the evidence before it. It should not go outside of the evidence, beyond the record, for its decision in this case where a clear cut issue has been made between the parties by the pleadings and competent testimony produced to sustain the burden undertaken.

If, however, the duty rests upon the court in such a case to examine the facts to ascertain whether the facts themselves justify the acceptance of the witnesses, the undisputed facts of this case could not possibly justify, to any reasonable mind, any conclusion other than that the testimony was entirely credible.

**More complete statement of undisputed facts.**

There was no dispute as to the material facts. Some of them are set out in the petition. A more complete summary is here furnished:

1. The petitioner is a corporation organized under the laws of Alabama in the year 1934 with a capital of $50,000.00. Since its organization it has been engaged in selling and servicing road and other machinery. It has only four stockholders, Mr. and Mrs. H. H. Toothaker and Mr. and Mrs. J. Lamar Burford. Mr. Toothaker and Mr. Burford are petitioner's only officers, serving in the capacities of president and secretary, respectively Burford and Toothaker devoted their undivided time and efforts to the service of the petitioner company. During the three years in question they worked six days a week and frequently on Sundays and at night. They performed not only the duties customarily performed by the chief executive officers of a business concern but also attended to many other duties in connection with its buying, selling, and servicing.

2. Burford and Tothaker worked together as a team, each taking the other's place in the office, plant, or field

as the exigencies of the business required. The duties and functions performed by them were numerous and varied. These duties are generally set out in a Company Procedure Manual (Exhibit 5) jointly prepared by them and based on their many years of experience in this kind of business. The company's business and affairs were managed and supervised solely by these two officers. Burford, with credit and accounting experience, supervised the financial affairs of the company, its credits and collections. Toothaker, with engineering and sale experience, organized and supervised the shop. Both participated in the sales. Each of them actively participated in the general management and supervision of all departments of the business. They personally participated in all sales involving trade-ins and credit. Each of them personally made sales and participated in closing sales made by their salesmen. They made frequent visits to the factories of the Caterpillar Tractor Company, whose sales franchise they operated in territory consisting of counties in south Alabama and North Florida. That they were recognized as unusually experienced and capable executives is shown by the fact that their plant was selected by the Caterpillar Company as a place for training some of its district representatives and further by the fact that on one occasion Toothaker was asked to and made a speech to the Caterpillar people about how to run a dealership. The employees under their supervision during the years involved were 56, 65 and 71, respectively.

3. During the years involved, Toothaker was 44, 45 and 46, respectively, and Burford was ten years younger. Toothaker's education and experience consisting of a high school education, attendance until his junior year at the University of Illinois studying civil engineering. After a period of war service in World War I, he attended the University of Grinoble in France, which was followed by two or three years' experience as a civil engineer with the

Illinois State Highway Department. He was then in the road contracting business about five years, following which he went into the construction machinery business, in which he handled accounts similar to those of the present company, where he remained three or four years. After that he was employed as Sales and Service Manager for the Lombard Company of its construction machinery department for about a year which was work somewhat comparable with the work of the present company. He and Burford then organized the Georgline Company in Augusta, Georgia, which handled the Caterpillar Tractor account with other road machinery accounts and they remained in it from 1931 until 1934, when the present company was organized. Burford completed high school. He worked in the machine shop of Lombard Iron Works & Supply Company, also in their supply and accounting department, and was cashier and in charge of the office at the time he left after ten years in its employ. He had several years experience in the tractor business before he and Toothaker organized the present company.

During Toothaker's employment with the Lombard Company, in which he held no stock and in which his duties and responsibilities were greatly less than in the present company, his compensation was a salary of $350.00 per month plus a percentage of one percent of sales from $150,000 to $200,000, and on the next $50,000 1½%, and on the next $50,000, 2%, and on everything over $300,000, 3%.

4. The work of the two officers was substantially increased during the years in question by new and added work in dealing with problems which arose in their business in connection with the war effort.[1]

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[1] This was found to be true by the Tax Court and excerps from its decision are quoted in the petition. There would have been even more testimony than was offered but the Tax Court judge suggested that he was satisfied.

5. The operation of the company required relatively large borrowings from banks which was as high as $425,000. All of these borrowings were individually guaranteed by the endorsement of Burford and Toothaker, who together had a net worth of approximately $500,000.

6. Under the management of Burford and Toothaker of the company with an initial capital of $50,000 and which was $150,000 during the three year period, the following results were accomplished in comparison with the preceding three year period: (Petitioner's Exhibit 4. Cents omitted).

| | 1937-8-9 | 1941-2-3 |
|---|---|---|
| Total sales | $2,954,935 | $5,689,300 |
| Sales of used equipment | 299,332 | 1,357,416 |
| Profit before federal income taxes | 97,827 | 581,124 |
| Federal income taxes paid | 18,009 | 425,584 |
| Profit after income taxes | 79,817 | 175,529 |

7. During each year of the three year periods the company paid a dividend of $12,000, which was 8% of its $150,000.00 capital.

8. After payment of all operating expenses, including bonuses to salesmen, the annual 8% dividend and the salaries in question, the company increased its surplus approximately from $94,000 to $354,000, an increase of approximately $260,000 on its capital of $150,000.

9. During the years in question the annual salaries of Burford and Toothaker were $9,000.00 plus 2% on all sales in excess of $300,000.00. This has been their basis of compensation each year since the company was organized in 1934, except in 1935 when the basis was slightly higher. The amount of the compensation paid to the two officers (total for the two), the total sales of the company, the profits (before federal income tax), the dividends paid

and the percentage of the officers' compensation to the sales for each year of the company's existence was as follows:

| Year | Compensation paid Burford & Toothaker (Total) | Total sales | Profits | Dividends | Percentage of officers' compensation of sales |
|---|---|---|---|---|---|
| 1935 | 23,538 | 430,773 | | | 5.4 |
| 1936 | 32,800 | 699,988 | 23,740 | 10,000 | 4.9 |
| 1937 | 40,986 | 874,660 | 23,994 | 10,200 | 4.7 |
| 1938 | 35,204 | 730,116 | 18,228 | 6,780 | 4.8 |
| 1939 | 46,530 | 1,013,260 | 38,653 | 10,560 | 4.6 |
| 1940 | 54,462 | 1,211,558 | 41,035 | 12,000 | 4.5 |
| 1941 | 79,844 | 1,846,111 | 82,578 | 12,000 | 4.3 |
| 1942 | 97,213 | 2,280,348 | 299,602 | 12,000 | 4.3 |
| 1943 | 68,492 | 1,562,840 | 198,943 | 12,000 | 4.4 |

A comparison of the compensation which Toothaker received from the petitioner company with what he would have been entitled to on the basis of his previous employment by the Lombard Company is as follows: (Petitioner's Exhibit 7)

| Year | Compensation received from present company | Amount on basis of Lombard Company employment |
|---|---|---|
| 1941 | 39,922.50 | 57,616.15 |
| 1942 | 48,606.50 | 70,360.47 |
| 1943 | 34,246.00 | 49,835.21 |
| Total — 3 year | 122,775.00 | 177,811.83 |

11. The company was examined by the respondent's agents for the three preceding years (1938-9-40) and the Technical Staff approved the salaries as reasonable. R. 12. The Board of Tax Appeals in the case of Burford-Toothaker vs. Commissioner, Docket No. 100911 decided that the salaries paid these officers for the years 1935-6-7 computed on the same basis (except slightly higher for one year, 1935), was reasonable.

With these as the undisputed facts, it is submitted that they justify **no other conclusion** than that the testimony of the witnesses was the **only** testimony that could have honestly been given.

**Comparison with other cases factually comparable.**

A comparison of the facts of this case with those of other comparable cases shows that not only was the compensation paid here "reasonable" but it was substantially less, measured by any yardstick, than what was approved by the Courts and the Tax Court itself for officers occupying similar positions in other comparable companies for the same approximate period. Thus:

A comparison of the record facts in **Roth Equipment Company vs. Gallagher** case, supra (172 $F^2$ 452) with those in the case at bar shows:

(a) In both cases the **years** were almost the same, 1941-2 in Roth, 1941-2-3 in present case.

(b) In both cases the stock was closely held—80% in Roth case.

(c) In the Roth case there was no bonus or additional compensation agreement made in **advance** but only after the amount of the profits were known. Here the compensation was fixed in advance and was standard in each of the years and had been the same (except for one year, 1935, for a larger percentage) in each of the years preceding.

(d) Whether the increase in the sales was due primarily to officers' effort or otherwise was a matter of dispute in the **Roth** case and in the instant case the Tax Court was not willing to attribute the increase in sales "altogether to the efforts of the two officers (R.46) even though the Court stopped Burford from testifying further in that respect on the hearing (R. 65, footnote 1, this brief).

(e) A comparison of **net profit** of the two companies, the compensation allowed as reasonable by the Circuit Court of Apeals, and the ratio of officers' compensation to net profit shows the following:

**Roth**

| Fiscal year | Net Profit | Compensation of officers | Ratio of officers' Compensation to net profit |
|---|---|---|---|
| 1941 | $38,958.00 | $46,452.00 | 119% |
| 1942 | $57,015.00 | $86,482.00 | 151% |
| | | | Average 135 % |

**Burford-Toothaker**

| | | | |
|---|---|---|---|
| 1941 | $82,528.00 | $79,844.00 | 96% |
| 1942 | $299,602.00 | $97,213.00 | 32% |
| | | | Average 64% |

The result is that the two year average percentage of officers' compensation to net profit allowed in the Roth case, 135%, is more than **double** the percentage, 64%, paid in the instant case.

(f) The record does not disclose any dividends paid in the Roth case while in the case at bar, the company regularly paid 8% each year on its stock, a total of $36,000.00 in dividends.

(g) Both cases involved war years. As to this the Sixth Circuit wrote in the **Roth** case:

"Although war conditions caused the industry in general to boom, yet there was keen competition for such increased business among the competing firms. The experience of the three officers, the contacts and good will established by years of work, hard work and long hours, plus the operation of the bonus plan enabled them to take advantage of the favorable situation and for a few years receive liberal compensation. But it was still compensation for personal services, and of a kind that is entitled to liberal compensation when the results were sufficiently successful to pay it."

"The fact that much of the increased business of the Company during 1941 and 1942 was due to war conditions does not seem to be very material. In a business involving the personal services of its officers, as in the present case, increased business meant increased work and increased responsibilities. War orders added the complicated factor of priorities. While unusual economic conditions brought on by the war is a factor to be considered in these cases, the Tax Court has held several times that this alone does not establish unreasonableness where war business has resulted in increased work and responsibility."

It is submitted that approval of the reasonableness of the officers' Compensation in the case at bar is justified even more than in the Roth case.

Comparison of the facts in **Wright-Bernet, Inc. vs. Commissioner,** supra (CCA 6) 172 F² 343, involving the reasonableness of officers' salaries for similar years—1942-3, two of the years involved herein shows:

1. In both cases the officers whose compensation was at issue (1) participated in sales, (2) performed administrative as well as executive duties, (3) worked exceedingly long hours, (4) were experienced and capable, (5) themselves owned a large majority of the corporate stock.

2. In that case the officers' compensation had been materially increased each year while here the basis had remained the same each year (except for a slightly larger basis in 1935).

3. Comparison of sales to officers' compensation in the two cases shows:

| Year | Sales of Wright-Bernet | Sales of Burford-Toothaker | Compensation of Officers of Wright-Bernet | Compensation of Officers of Burford-Toothaker | Percentage of Compensation to Sales Wright-Bernet | Percentage of Compensation to Sales Burford-Toothaker |
|---|---|---|---|---|---|---|
| 1942 | $757,000.00 | $2,280,349.00 | $61,600.00 | $97,213.00 | 8.14% | 4.26% |
| 1943 | 570,000.00 | 1,562,840.00 | 73,840.00 | 68,492.00 | 12.95% | 4.32% |

This comparison shows the Burford-Toothaker officers' Compensation considerably less than half the percentage of that in Wright-Bernet.

4. A comparison of officers' compensation to net profits before taxes shows:

| Year | Wright-Bernet Profits Before Taxes | Burford-Toothaker Profits Before Taxes | Wright-Bernet Officer Compensation | Burford-Toothaker Officer Compensation | Percentage Compensation to Profits Before Taxes Wright-Bernet | Percentage Compensation to Profits Before Taxes Burford-Toothaker |
|---|---|---|---|---|---|---|
| 1942 | $167,783.00 | 299,603.00 | $61,600.00 | $97,213.00 | 36.7% | 32.4% |
| 1943 | 40,518.94 | 198,943.00 | 73,840.00 | 68,492.00 | 182.0% | 34.4% |
| 2-Year average — Ratio Net Profits Before Taxes to Compensation | | | | | 109.4% | 33.4% |



This comparison shows the percentage of officers' compensation to net profits before taxes in Wright-Bernet to be more than **three times** that of Burford-Toothaker. A like tabulation of ratio of officers' compensation to net profits **after** taxes shows:

This shows the average to be about 2.46 times greater in the Wright-Bernet case, than in Burford-Toothaker case, as detailed below:

| Year | Wright-Bernet Profits After Taxes | Burford-Toothaker Profits After Taxes | Wright-Bernet Amount of Compensation | Burford-Toothaker Amount of Compensation | Percentage Compensation to Profits After Taxes Wright-Bernet | Percentage Compensation to Profits After Taxes Burford-Toothaker |
|---|---|---|---|---|---|---|
| 1942 | $37,217.50 | $75,154.00 | $61,600.00 | $97,213.00 | 178.0% | 129.0% |
| 1943 | 14,376.80 | 56,440.00 | 73,840.00 | 68,492.00 | 513.0% | 121.0% |
| | | | Wright-Bernet | | Burford-Toothaker | |
| Average for two years | | | 345.5% | | 125.0% | |

In the Wright-Bernet case the Tax Court had, as here reduced the amount of officer's compensation to a figure selected by the court in disregard of the testimony. In its opinion the Circuit Court wrote that the "success of the business is shown by the record to be due mainly to the work of the four employees whose salaries are in question." That is true here.

There, the Circuit Court in referring to the rule as to the presumptive correctness of the Commissioner's determination wrote:

> "The Tax Court considered that this case did not require the application of the doctrine of the presumptive correctness of the Commissioner's determination, and decided that it called for a decision upon its facts. While the findings of fact give full credit to the experience, qualifications, ability, and unusual industry of the four employees, and the Tax Court reduced the deficiencies found by the Commissioner, it made substantial reductions in the salaries fixed by the corporation."

There, as here, the employees whose salaries were in question, testified that they were reasonable and a third party corroborated them just as the witness Aldridge, an independent certified public accountant, testified that the compensation was reasonable and even less than in a comparable instance (R. 74).

What was held and written in that case is applicable here, namely:

> **"As the petitioner's witnesses were qualified and unimpeached, and no evidence was given to the contrary, their testimony should have been accepted.** Capital-Barg Dry Cleaning Co. v. Commissioner, 6 Cir., 131 F 2d 712."

A case decided by the Tax Court, **North Carolina Equipment Company** (Docket 4737, decided June 4, 1945) involving the reasonableness of officers' salaries for one of the same years as here, is comparable.

(a) The North Carolina Equipment Company was operating in the same kind of business as Burford-Toothaker and handling some of the identical lines of equipment and the background and experience of the president of the North Carolina Equipment Company case is strikingly parallel to that of Toothaker, the president here, and his duties were closely similar.

(b) There, as here, the officers involved owned a large majority of the stock.

(c) Compensation of officers in that case as here was based on a fixed salary with additional compensation or "bonus." In that case instead of the additional compensation being based on a small percentage of the sales above a certain fixed amount as here it was based on a large percentage of the profits.

(d) For the year 1941 the North Carolina Equipment Company paid to its officers 55.6% of its total compensation to all employees, of which 33.8% was paid to its president while here the amount paid to all officers was but 43.2% of total compensation paid all employees and the president here was paid only about 21.6% of the total as against 33.8% paid there to the president.

(e) A comparison of the dividend record of the two companies, using the five years of figures shown in that case with the record of the company in the case at bar shows the percentage of dividends of the North Carolina Company to be an average of 8.06% of its original invested capital compared to 21.39% in the instant case or more than double. As the courts seem to place value on dividend payments in determining reasonableness of compensation

paid to officers, these figures indicate that on this basis of comparison as well as others, the compensation in the instant case was proportionately smaller than that approved in the North Carolina case.

(f) On a sales volume basis, for the year 1941, the president who owned more than 50% of the stock was paid compensation which amounts to 2.8% of the sales as compared to 2.165% to the president in the case at bar. In that case all officers drew 4.72% of sales compared to 4.33% for the corresponding year in the instant case and an average for the three years of $4.30%.

Thus on every fair basis of comparison the officers' compensation in the case at bar is substantially less than that approved as reasonable in the North Carolina Equipment Company case for officers doing closely similar work.

**Mayson Manufacturing Company vs. Commissioner,** (CCA 6), 178 $F^2$ 115, is another case where the officers whose compensation was in question and their immediate families owned all the corporate stock. While the year 1943 was the only one involved so as to offer a comparison with the case at bar. A comparison of officers' compensation with sales of the two companies for the three years shows:

| Year | Mayson sales | Burford-Toothaker sales | Mayson Officer's compensation | Burford-Toothaker officers' compensation | Mayson puercentage of compensation to sales | Burford-Tothaker percentage of compensation to sales |
|---|---|---|---|---|---|---|
| 1941 | $396,653.00 | $1,846,111.00 | $ 78,258.00 | $79,844.00 | 19.7% | 4.33% |
| 1942 | 499,791.00 | 2,280,349.00 | 105,122.00 | 97,213.00 | 21.0% | 4.26% |
| 1943 | 696,498.00 | 1,562,840.00 | 137,745.00 | 68,492.00 | 19.8% | 4.32% |
| 3-Year average of Percentage of Compensation to sales | | | | | 20.17% | 4.30% |



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The significant point of this comparison is that the officers in the Mayson case approved by the Sixth Circuit for 1943 was considerably more than **four times** as much in relation to sales as in the case at bar and that was true also in the other years under consideration.

Attention is called also to the fact that for the year 1943, the sales of Burford-Toothaker were 2¼ times those of the Mayson Company, yet the compensation of officers of the Mayson Company was more than double that of Burford-Toothaker for that year. The ratios for the other years are even more favorable to Burford-Toothaker as to reasonableness of compensation.

The results obtained should be given weight. Comparison of the Mayson Company case and Burford-Toothaker case shows:

| Year | Amount of Profits of Mayson before taxes and officers' compensation | Amount of profits Burford-Tothaker before taxes and officers' compensation | Ratio of officers' compensation to profits before deducting compensation and taxes Mayson | Ratio of officers' compensation to profits before deducting compensation and taxes Burford-Toothaker |
|---|---|---|---|---|
| 1941 | $129,591.00 | $162,422.00 | 60.4% | 49.1% |
| 1942 | 200,359.00 | 396,816.00 | 52.5% | 24.5% |
| 1943 | 314,721.00 | 267,435.00 | 43.1% | 25.6% |
| 3-Year Average Percentage | | | 52.0% | 33.1% |

These figures show that for these three years the officers of the Mayson Company received as compensation an average of 52% of the profits for the three years, while the officers of Burford-Toothaker received an average of only 33.1% for the same three years. It should be noticed also that in the Mayson case the additional compensation

paid officers was based on a **high percentage** of the net **profits** as compared to a **small percentage** of the sales in excess of a maximum basis in the present case. In deciding whether officers' compensation is dividends in disguise, there is certainly more logic for assuming that percentages of compensation as based on profits are dividends under the guise of compensation than in assuming that a small percentage of sales above a certain figure may represent dividends. The former method of determining additional compensation was followed in the Mayson case and the latter method in the case at bar.

A fair comparison of the facts of the comparable cases —Roth, North Carolina Equipment, Mayson Manufacturing, and the Wright-Bernet—in all of which the officers' compensation was held to be reasonable, should leave no doubt as to a similar conclusion here.

**Comparison with previous board decision.**

By way of further comparison attention is called to what the Board of Tax Appeals wrote concerning the reasonableness of the compensation of **these identical officers,** in its 1940 decision dealing with the years 1935, 6 and 7. (Docket 100911 Oct. 20, 1940; Exhibit 2):

> "In the instant case we are convinced that Burford and Tothaker, the two officers, personally built up petitioner's business through their diligence and ingenuity. They devoted their entire time to management of the petitioner and even financed the corporation personally on several occasions. Petitioner's profits can largely be attributed to the personal activity of its two officers. Regardless of the fact that the officers and their wives owned all petitioner's stock equally, nevertheless self-awarded bonuses would not be unreasonable or necessarily disguised dividend distributions if: (a) like concerns in like circumstances paid

like officers a comparable salary, and (b) the officers actually performed the duties of these officers or (c) it can be otherwise proven that the circumstances involved merited the additional compensation for services actually rendered."

The Court then made a comparison between the basis of Toothaker's compensation when employed by the Lombard Company, a road machinery concern, in a position with somewhat similar sales duties under a contract for a monthly salary and a percentage of sales with the basis of his compensation as an employee of the present company with the result that in each year his compensation figured on the Lombard basis would have produced a larger amount than he drew as an officer of the present company.

The same comparison continues to be true in the instant case where in each of the three years his Lombard compensation would have substantially exceeded his salary with the present company. During the three year period the columns shown in Petitioner's Exhibt 7 show that the compensation paid Toothaker in the three years in question was $55,026.83 less than that he would have been entitled to on the same volume of sales under the Lombard agreement.

The favorableness of this comparison in this case is increased by consideration of the fact that in his present position Toothaker has many executive and other duties as President of the company which he did not have as Sales and Service Manager of but one of Lombard's departments.[2] Moreover, he did not have to pledge his individual resources in obtaining financial assistance for the company as he did for the present company.

The Court concluded that on the basis of that criterion the compensation paid to the officers in that case was

[2] Construction machinery department.

reasonable. On the basis of the same criterion applied here, the result would be the same.

But the Court in that case did not confine itself to that one test but went further and held that:

> "Thus far we have only considered the reasonableness of the compensation by comparison with a like concern. We do not, however, rest our conclusion merely upon this comparison but by scrutinizing the petitioner's books in the light of the facts adduced, we arrive at the same conclusion on other grounds. Petitioner declared large proportionate dividends in 1936 and 1937 and by the close of its third full year of business had built up an undistributed surplus equal to more than half of its outstanding common stock, and its sales' volume had been more than doubled in this same space of time. All this was due mostly to the efforts of Burford and Toothaker. When faced with a successful corporation such as this which actually declares dividends qua dividends and builds up a surplus after all compensation and expenses are paid, we hestitate to find officers' compensation unreasonable unless it is unconscionably large in ratio to the duties performed. Neither officer's salary here could be said to be unconscionably large in view of his efforts and the satisfactory results obtained thereby. The fact that the corporation is a "close" one merely arouses suspicion, which, when the circumstances are examined, proves to be false. The entire compensation paid to each officer for each of the years in question was reasonable."

Attention has already been called to the fact that in addition to their regular work, these two officers in the abnormal years here under consideration had greatly increased work. As was stated by the Tax Court Judge during the hearing: "It doesn't take very much to convince

me that the war effort did increase the duties of business men." (R. 64)

Not only were their duties and strain increased (Toothaker has since died) but the money they were paid was worth considerably less than in prior years due to the drop in purchasing value from 101.9% in 1935 to 80.9% in 1943, according to Commerce Department figures.

The Internal Revenue Bureau's "Committee on Appeal and Review Recommendation" has had this to say about an established practice of salary payment:

> "Established Practice.—Where salaries have been fixed long before any Excess Profits Tax Law was contemplated, the Income Tax Unit is not authorized by the law or regulations to arbitrarily change the amounts deductible. Neither is the Unit authorized to look back of any corporation resolution fixing salaries after the passage of the Excess Profits Tax Law, provided there is no evidence of intent to reduce the the tax of the corporation, and provided that after deducting the amount fixed and paid the corporation has a normal return on its invested capital left, or where such deduction does not reduce the net earnings subject to tax below that of competing concerns which secure the services of officers and employees by open bargaining." A. R. R. 53, 2 Cumulative Bulletin, 110.

To the same general effect is William S. Gray, 68 Ct. of Cl. 43, 35 F² 968:

> "The policy of agreeing to pay a percentage of the earnings before they are earned, or even a sum in the nature of a bonus after they are earned, is based primarily upon sound business principles."

If, therefore, it is necessary for the Court to examine the testimony for credibility or to compare decisions in

other cases it would seem that the comparisons here furnished would leave no room for doubt as to the credibility of the witnesses here and the error of the Courts below.

**Equitable Estoppel.**

The final point is whether the technical requirements of the rule of equitable estoppel were met in this case so that the decision in the former decision was controlling here because of fact that (a) the parties are identical, (b) the issue as to whether officers' compensation paid is identical, (c) the same general kind of services are involved, and (d) the basis for computing the officers' compensation is identical in two of the former years and slightly less than in the other? The Tax Court in its opinion held that although these matters are the same in each case, the fact that the present case pertains to a different period (difference in years only) and different conditions (harder, if anything), actually prevents the application of the rule of res judicata or "equtable estoppel."

On this point it is submitted that what was written in **Bennett vs. Commission,** CCA 5, 113 F$^2$ 837, is applicable:

> "Res judicata rests on a rule of public policy designed to put an end to mere contentious litigations. Under that rule an issue once finally settled by the judgment of a court of competent jurisdiction remains settled. . . . "
>
> " . . . that the doctrine of res judicata applies to cases in courts under the tax laws, and that where the parties are the same and the questions identical, the fact that **different tax years** are involved will not prevent its application." (Emphasis supplied)

In this case the corporate taxpayer had, from the beginning, established a system of officer compensation on the basis of salary plus percentage of sales. The amount

it paid on this basis was questioned by the Commissioner for the first three, 1935, 6, 7, and upheld and approved by the Board of Tax Appeals. It paid on the same basis for the next three years, 1938-9-40. The Commissioner again questioned the amount and his officers charged with the responsibility of settling such matters considered it and approved it. Thus for the second time the government, by its proper officials, considered and approved the amount arrived at on the salary and percentage of sales method.

The company with its first six years approved, continued to pay on the same basis for the next three years, 1941-2-3, but then the same court which had previously approved the amount computed on the salary and percentage of sales method reverses itself and holds the other way.

This is a case where every equitable consideration requires that the rule of res judicata or equitable estoppel be invoked both on the legal considerations present and also on the basis of simple justice.

## CONCLUSION

It is submitted that for the reasons stated, this Court should accept this case, rectify the unjust result of the Court below and settle the question of what is a "reasonable" allowance for compensation and hold that when qualified and informed witnesses and with no testimony to the contrary, testify (without impeachment) that the amount paid is reasonable, the court should accept the testimony and not go outside the record and make an independent determination unsupported by anything in the record.

Respectfully submitted,
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March 1952